Saudi Arabia/Riyadh on the path of economic and social differentiation

The next move

Undertaking the biggest economic transformation in its history while attempting to gauge the constantly shifting dynamics of the oil and energy markets, the Saudi Kingdom faces key decisions in the year to come

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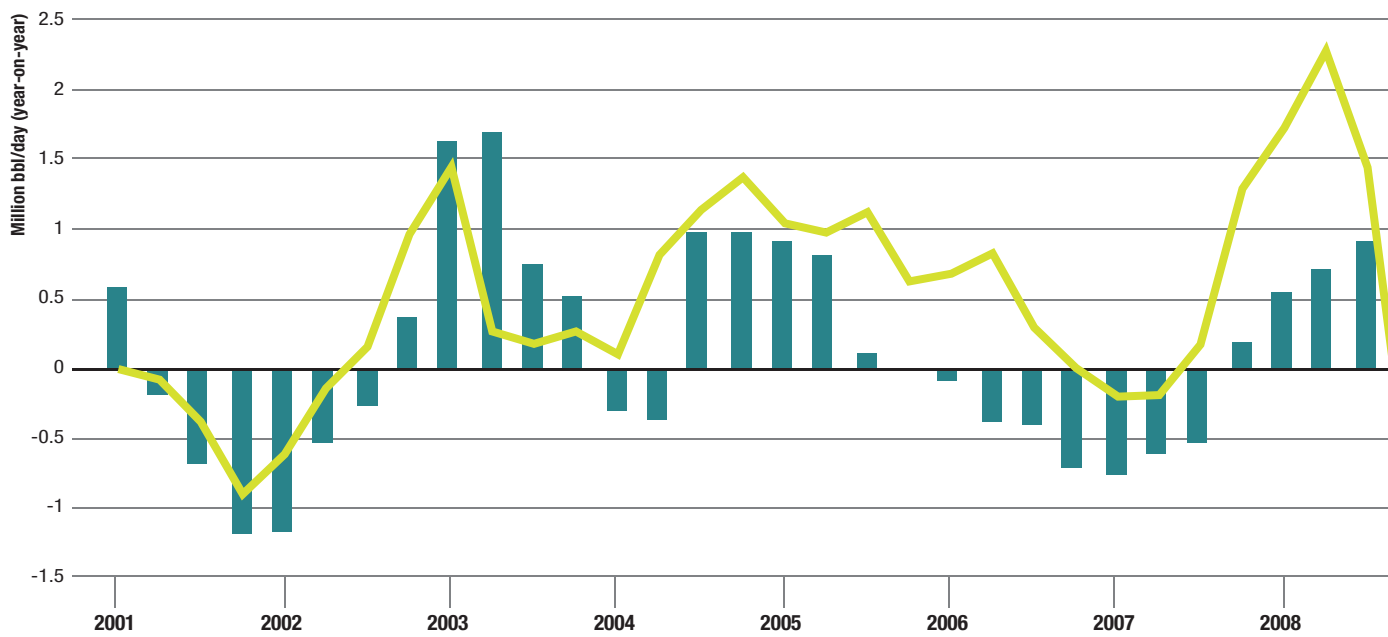
The shift in Saudi oil policy in 2016—from pursuing a market share strategy to engineering an output cut—has come under close scrutiny. Some have argued that this shift is a recognition by Saudi policymakers that their policy so far has been a "pretty comprehensive strategic failure" due to "a mixture of hubris, inexperience and, most important, a failure to understand ... how a genuine market economy works, which is why all the rhetoric about new economic plans for the country built on a fairy tale presentation from consultants is going nowhere..".[1] Others are of the view that Saudi Arabia has finally blinked, conceding defeat in its war against U.S. shale. Others argue that Saudi Arabia is in "financial crisis" and "panic mode" and therefore "desperate" to reach an output deal. While such accounts tend to capture the public imagination, they are of very limited use for understanding the evolution of Saudi oil policy. They tend to see the oil market as static and in black and white. These accounts also embody an implicit assumption that Saudi oil policy is constant and cannot be based on a rational calculation of the benefits and costs that tend to change over time. But, as has been argued by this author on multiple occasions, Saudi oil policy is shaped by various sets of factors that include: developments in the local economy, dynamics associated with OPEC and non-OPEC producers, the nature of the oil market shock, and the change in oil market conditions. As these factors change and as new information becomes available, Saudi oil policy will also adapt.

Four phases of Saudi oil policy

Since 2008, Saudi oil policy has passed through four distinct phases. In the first phase, one that followed the collapse in oil demand in the aftermath of the 2008 financial crisis, OPEC implemented one of the biggest cuts in its history, with Saudi Arabia accounting for the bulk of the cut. Saudi Arabia also sent a strong signal about its preferred price of $75 per barrel. As the global economy recovered and as oil demand started picking up, oil prices stabilized around $75 per barrel for the second half of 2009 and for most of 2010. But prices started rising at the end of 2010 with the start of the "Arab Spring" in Tunisia and as the risks of spillovers to other Arab countries were becoming more visible. Between 2011 and 2013, the market witnessed some serious supply disruptions, mainly from the Middle East and North Africa. During this second phase, Saudi Arabia played its preferred role: increasing output to offset the supply disruptions. Saudi oil output mirrored closely the supply disruption at the time. The first surge in Saudi output occurred in the aftermath of the Libyan disruption in 2011, while the second followed the imposition of sanctions on Iran, which cut Iran's exports sharply. In 2011 and 2012, Saudi Arabia's production increased by 0.96 mb/d year-on-year and 0.41 mb/d respectively, reaching 10.1 mb/d in August 2013. These output increases were not enough to compensate for supply outages and the market had to rely on the rapid increase in U.S. shale oil to meet the supply gap. As supply disruptions eased, Saudi output declined below 10 mb/d towards the end of 2013 but remained above 9.5 mb/d until the end of 2014. During this phase, Saudi Arabia revised its preferred price upward to $100/barrel, indicating →

Price & Output



Oil production levels in Saudi Arabia before 2016 affected, almost synchronously, the trend in crude oil prices. However, if the OPEC agreement is fully complied with, the situation could take a different turn.

that the preferred price was a moving target reflecting market conditions at the time. The oil minister at that time, Mr Ali Al-Naimi, warned against very high international oil prices, which were bad news for Europe, the U.S., emerging economies and the world's poorer nations. The Kingdom would therefore act to lower a soaring oil price, and Mr. Ali Al-Naimi sent clear signals that $100 was a fair price for everybody: consumers, producers and oil companies. These relatively high and stable oil prices generated both strong demand and supply responses, especially from U.S. shale. In the first half of 2014 U.S. supply growth alone exceeded that of global demand, contributing to a large build of stocks in that year.

Limited options and reactive policy

In mid-2014 Saudi Arabia was reacting to a huge market imbalance caused by the economic forces unleashed by high oil prices. Faced with this imbalance, the Kingdom was left with two options: either cut output, or leave it to the price mechanism to balance the market. In November 2014, Saudi Arabia opted for not cutting output and instead ramped its output in an attempt to increase its market share at the expense of high-cost producers. There are multiple factors that shaped Saudi Arabia's decision at the time:

- The size of the market imbalance in Q4 2014 was relatively large.
- Saudi Arabia has been unwilling to act unilaterally to balance the market. This is a fundamental principle which was shaped by events in the mid-1980s, when its attempt to protect the oil price resulted in a large loss of volumes of production and market share, without succeeding in increasing prices. This resulted in a significant loss of revenues.
- There was difficulty reaching an agreement within OPEC and with non-OPEC producers. Many producers had not felt the pain of lower revenues at that point, and hence they did not show much willingness to act. Also, key producers such as Iraq, Kuwait, and the UAE were increasing output and had ambitious plans to increase productive capacity, and they did not want to be subject to any quota system. Saudi Arabia was also not keen to lead the negotiations, perhaps in the belief that such efforts would not result in a meaningful agreement with other producers.
- During the boom years, Saudi Arabia had built strong fiscal buffers by accumulating large foreign reserves and reducing its debt to very low levels. This may have created a general belief among Saudi policymakers that the Kingdom could withstand lower prices for longer.
- The rise of U.S. shale introduced a new set of structural uncertainties, particularly relating to U.S. shale supply response and, more generally, to the nature of the shock hitting the market.

In an environment of structural uncertainty and non-cooperation from other producers, it can be shown in a game theory framework that Saudi Arabia is better off not cutting output. During this third phase, therefore, Saudi Arabia ramped its output sharply. In 2015, Saudi Arabia was one of the main contributors to supply growth (the other was Iraq), adding more than 400,000 b/d. In 2016, Saudi output reached a record level of around 10.8 mb/d.

The cost–benefit calculus

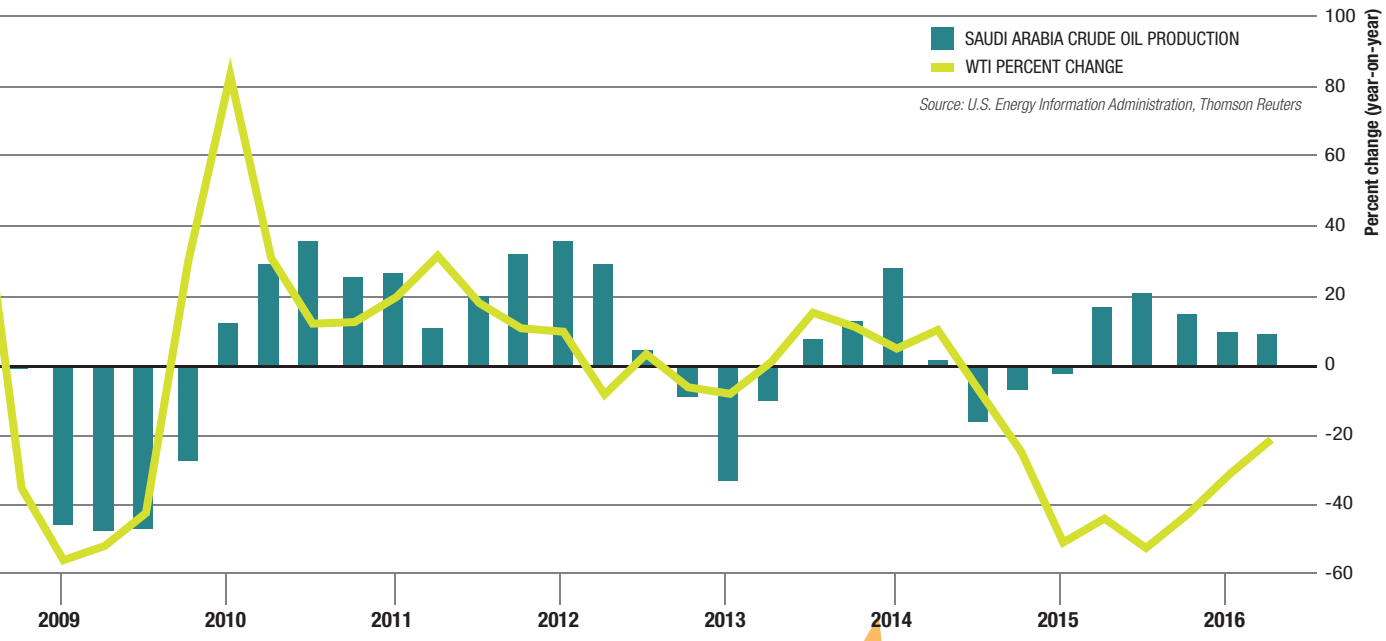
Any policy is associated with both costs and benefits, and the policy of pursuing market share adopted by Saudi Arabia back in November 2014 is no different. The increase in output did allow Saudi Arabia to maintain, or even increase marginally, its share in global oil supply, but the increase in output did not compensate for the decline in oil revenues. In 2015, Saudi Arabia's revenues fell by almost 50 percent from the previous year. In the long term, such a market share strategy could result in higher revenues if existing sources of supply exited the market or potential suppliers were deterred from entering. However, as noted by Robert Mabro, "prices have to fall a long way and price expectations have to remain depressed for a long time for a significant improvement of the market share." Maintaining such a strategy thus requires that an oil exporting country is financially resilient if faced with a prolonged period of low oil prices. It should be able to: rely on its fiscal buffers, adjust its economy to the low oil price environment,or reduce reliance on oil revenues by diversifying its economy. But fiscal buffers are temporary and can erode fairly quickly, especially if the government's spending unexpectedly increases. Adjusting the economy can be very painful and not all governments are capable of shifting the burden of adjustment to their populations. Diversifying a country's economy is a long-term process that has eluded most oil exporting countries. Saudi Arabia is no exception, and its economy, despite many efforts to diversify and build a vibrant private sector, still relies heavily on oil revenues.

While the costs of such strategies can be large, the size and the timing of benefits are uncertain, as these will depend on the adjustment processes of other producers. High-cost producers can reduce their cost structure through efficiency, high-grading, and cost deflation in the supply chain. Furthermore, the long lead times of capital-intensive projects mean that the supply response to low oil prices is not immediate, even for very high-cost producers. Finally, for low-cost oil producers, the response to price signals may take longer, especially if they pursue a policy of maximizing production at any cost in an attempt to boost revenues.

A calculus that changes over time

A key point is that the cost–benefit calculus is not static and is a function of time. Oil output did decline in many parts of the world in response to the sharp fall in the oil price from its peak in June 2014. Despite efficiency gains, U.S. shale has been leading the way, with annual growth turning negative in 2016. In mature areas such as Mexico, China, and Colombia, output declines have been sharp. Even in some parts of OPEC outside the Middle East such as Venezuela and Nigeria fiscal crisis and instability have resulted in large losses of production. These declines in output, accompanied with fairly robust demand in 2015 and 2016, helped the market to rebalance, but perhaps not as quickly as many were predicting. Some key producers mainly in the Middle East and Russia continued to invest in their energy sectors and increased their output even in the low-price environment. Projects sanctioned in the high oil price environment continued to come online, offsetting some of the declines in supply.

But while the oil market was showing signs of rebalancing, the Saudi economy was feeling the pain of lower revenues. Despite its relatively strong fiscal buffers in comparison to other OPEC countries, the Saudi economy has been squeezed by low oil prices. After achieving an annual →



Which horizon?

Despite the consensus offered by the OPEC agreement on oil production cuts, Saudi Arabia keeps a watchful eye on the behavior of its direct competitors in order to maintain its leadership position in the global crude oil markets.

Below are four possible scenarios that could prefigure in the event of international "turnarounds".

1

If other countries do not comply with the agreement on production

Saudi Arabia could decide to move towards a policy aimed at increasing production, thereby reducing the expected advantages of non-compliance.

2

If U.S. shale production were to snap up the market share vacated by OPEC's cut in production

Riyadh would likely increase its production again, as the cuts would result in too large a loss of market share and related income.

3

If the U.S. shale response proves to be moderate

The most likely scenario is that at the next OPEC meeting, an extension of the current agreement will be enacted.

4

If the market shrinks more rapidly than expected, due to, for example, interruptions in supply

Saudi Arabia could attempt to place a ceiling on oil prices by increasing production, or it could allow stocks to run out more quickly, with a risk of further increasing prices.

A SLOW REBALANCING
Before the recent OPEC agreement, oil production plummeted in many areas of the world (including Mexico, China, Colombia, Venezuela and Nigeria) following the sharp fall in prices. This decline, along with a rather strong demand in 2015 and 2016, helped to rebalance the market, but less rapidly than expected.

real growth rate of 3.6 percent and 3.5 percent in 2014 and 2015 respectively, economic growth is projected to have slowed down to 1.2 percent in 2016. Lower government spending and tighter credit have had knock-on effects in the private sector, which still relies heavily on public spending. Growth in the private sector almost stalled, while that in the non-oil sector turned negative in Q4 2015 and Q1 2016, before recovering slightly in Q2 2016. Faced with a ballooning fiscal and current account deficit, the Saudi government has been forced to take a series of painful measures. Back in December 2015, it increased fuel and electricity prices, and some of these increases have been sharp. though from a very low base. Government spending on capital projects has also been cut. According to media reports, the finances of thousands of projects including transport, housing, and healthcare valued at about $69 billion have been reviewed and as much as a third of them may be cancelled. The government has also cut public sector allowances. In addition to adjusting public spending, the government has been running down its foreign reserves and increasing its local and foreign borrowing. For the first time, Saudi Arabia has tapped international bond markets, raising $17.5 bn in a new bond issue.

While these adjustments have been sharp and somewhat expected in an environment of lower oil prices, the country is neither in crisis nor in panic mode. The debt-to-GDP ratio is still relatively low and access to local and foreign debt markets is still open, with the latest bond issue showing great appetite from investors. Foreign reserves are still relatively high, the government has many attractive public assets earmarked for sale, and it has plans to boost revenues by introducing some indirect taxes such as VAT and other fees, charges, and excise duties. But low oil prices have forced the government to tighten the economy at a quicker pace than originally planned. and there is a realization that the persistence of the low oil price environment will limit the government's options looking forward. The slowdown in the private sector and in the non-oil economy implies that the much-needed job opportunities for the Kingdom's young population will be expanding at a slower pace than originally anticipated, and the government's plans to rationalize public sector employment will face a setback. The valuation of some assets, such as the partial IPO of Saudi Aramco, will also be positively correlated to the oil price. In other words, while low oil prices have been conducive to kick starting reforms, a persistent low oil price environment will make these reforms more difficult both politically and socially and could derail Vision 2030 if the private sector and non-oil economy are further squeezed and job creation stalls.

The agreement on output cuts

One critical juncture for the oil market was the fall in the oil price below $30/barrel at the beginning of 2016. Some were of the view that regardless of what happened to the oil price, there would be no reaction from the Kingdom. But Saudi Arabia did react, signalling to the market that the low oil prices in January 2016 were "irrational" and showing a willingness to cooperate with other OPEC and non-OPEC producers to freeze production. The Doha Agreement in April 2016 was a missed opportunity for producers to reach an agreement to freeze output and it created a sense of overall bearishness in the market. It also created a feeling that producers could never reach an agreement, especially as the relations between Saudi Arabia and Iran continued to deteriorate and Saudi-Russian relations reached a new low at that point. But the efforts by producers to reach an agreement did not stop. As we progressed into 2016 the signal shifted from freeze to output cut; equally importantly, Saudi Arabia took a leading role in these negotiations with the appointment of a new oil minister Mr Khalid Al-Falih. But during this period, Saudi Arabia's output remained elevated, reaching record levels in the summer of 2016. This increase can't just be explained by by heightened demand due to the rise in electricity demand during summer; Saudi Arabia was positioning itself for long and hard negotiations, and it is always better to negotiate from a higher level of output. The negotiations culminated in an agreement in November 2016 to cut the production

of OPEC member countries by 1.2 mb/d and eleven non-OPEC countries by 0.58 mb/d, led by Russia with 0.3 mb/d.

Potential explanations for the shift in policy

So the key question remains: What factors could explain this shift in Saudi behaviour? There are four potential explanations:

1 | Producers have shown more willingness to cooperate as oil revenues collapsed and the adjustment to low oil prices has become too painful.
2 | The market resolved a key uncertainty regarding U.S. shale response.
3 | The market has already rebalanced, so the expected benefit of the cut has increased and the cost of obtaining information about shale response on the upside is relatively low in a tight market.
4 | The cost of pursuing the market share strategy by Saudi Arabia has exceeded its benefits.

The first explanation is a possibility, but the producers' willingness to cooperate can be thought of as being more of an enabling factor in reaching the output deal in 2016. Saudi Arabia has always made it clear that it would not act unilaterally, and any agreement should be part of a collective effort by both OPEC and non-OPEC producers. An enabling factor for the agreement has been the closer relations between Russia and Saudi Arabia following the meeting between President Putin and Deputy Crown Prince Mohammed bin Salman on the sidelines of the G20 meeting in China in September 2016. This initiated a process of greater cooperation between the two countries.

The second explanation is less convincing, as there is no evidence that uncertainty regarding U.S. shale in the market has been resolved, especially with respect to the U.S. shale supply response to higher prices. The jury is still out on the question of how quickly and how big the response of U.S. shale would be, and at which price level we could see sharp increases in U.S. shale to offset the agreed cuts. The third explanation is more plausible. The gain from an output cut has increased over time as the market has become tighter. In other words, the timing of the cut matters: the cut in a tighter market will have a bigger impact on price and on revenues. Obtaining information on U.S. shale response can also be a side benefit of the output cut. The fourth explanation, based on cost, is perhaps the most plausible. There is plenty of evidence suggesting that oil-exporting countries, including Saudi Arabia, have been hit hard by low oil prices. But there are some potential variants for an explanation based on costs:

- At the time when the decision to cut was made, the cost had become so high that the net gain from the market share strategy had become very small.
- The cumulative costs since November 2014 have grown faster than cumulative benefits, wiping out the net gain from the market share strategy over time.
- When the decision to increase production was first made in 2014, Saudi Arabia may have overestimated its financial resilience and its tolerance to the costs associated with adopting a market share strategy.
- When the decision was first made, Saudi Arabia may have underestimated the cost of adopting a market share strategy, as not all information was available at the time of the decision.

Rather than a single factor, it is most likely that a combination of these cost factors, plus the higher expected benefit of a cut in a tighter market, all contributed to the shift in oil policy.

Possible scenarios looking forward

Given that Saudi Arabia's oil policy is constantly evolving, one should not exclude the possibility of further shifts in that policy in the next few months. But given that the costs associated with abandoning the output cut are high, only some extreme (but possible) changes in the behavior of other players, or in oil market dynamics, could push Saudi Arabia into shifting its oil strategy. Instead of trying to predict the next move, below are some potential scenarios:

- If there is no adherence to the output agreement by other countries (this does not mean that there must be 100 percent compliance), then the most likely outcome is a shift in Saudi policy towards increasing output, as other producers will substitute the cut in Saudi output, reducing the expected benefit from the cut. That's why in addition to considering U.S. shale, it is also important to look at the production profile of other countries such as Libya and Nigeria that were exempt from the cut agreement.
- If the U.S. shale response is big and fast and it substitutes for the OPEC output cut, Saudi Arabia is most likely to shift back to increasing production, as the current decision to cut output would result in loss of market share without any durable impact on prices, and hence in lower revenues. So far, there is no strong evidence to suggest that there will be sharp increases in U.S. shale output strong enough to offset the entire OPEC and non-OPEC cut if prices remain at these levels.
- If the U.S. shale response is moderate, and does not substitute for the agreed output cut, then the most likely outcome is an extension of the current agreement in the next OPEC meeting. This is a good scenario for Saudi Arabia as it would achieve three related goals: set a floor on the oil price, accelerate withdrawal of stocks (the key objective of the current OPEC agreement) and shift the forward price curve into backwardation.
- If the market tightens faster than expected (for instance due to a supply disruption) Saudi Arabia can attempt to put a cap on the oil price by increasing output, or it can let stocks draw faster, at the risk of letting prices go higher. The decision will be shaped by many factors including the Kingdom's view on how quickly output in other parts of the world would respond to higher prices.

OPEC's decisions have always been important for shaping market dynamics but the decision to cut output in 2016 is critical, as it will not only be key to resolving a fundamental uncertainty about a shock hitting the market, but it will also shed more light on Saudi Arabia's behavior in a more uncertain world. In this uncertain world, the Kingdom is currently undertaking the biggest economic transformation in its history, reconfiguring its geopolitical alliances and facing different dynamics within OPEC with the comeback of Iran and Iraq, while still learning about a new source of supply with a different investment cycle and business model and the potential to achieve large efficiency gains.

1 Nick Butler, "The Saudis' Strategic Failure", *The Financial Times*, october 10, 2016.